

Internal Revenue Service

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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:CORP:3-PLR-122468-98

Date:

March 29, 1999

Distributing =

Controlled =

A =

B =

C =

State X =

Business 1 =

Date 1 =

Date 2 =

a =

b =

This letter responds to your request dated December 15, 1998, for rulings on the federal income tax consequences of a proposed transaction. You submitted additional information in letters dated January 15, 1999, February 4, 1999, February 8, 1999, and

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March 3, 1999. The information submitted for consideration is summarized below.

Distributing, a State X corporation, was incorporated on Date 1 and elected to be treated as an S corporation (within the meaning of § 1361 of the Internal Revenue Code) effective as of Date 2. Distributing uses the cash method of accounting and has a calendar taxable year. Distributing is engaged in Business 1. A owns a% of the total issued and outstanding common stock of Distributing while B and C each own b% of the remaining issued and outstanding common stock.

We have received financial information indicating that Distributing has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Certain disputes have arisen between A, on the one hand, and B and C, on the other, that are adversely affecting the business of Distributing.

Therefore, the taxpayers have proposed (and partially consummated) the following transaction:

- (i) Controlled has recently been formed as a State X corporation. Controlled will use the cash method of accounting and have a calendar taxable year.
- (ii) Distributing will transfer certain assets of Business 1 to Controlled in exchange for all of the stock of Controlled.
- (iii) Distributing will distribute all of the Controlled stock equally to B and C in exchange for all of their Distributing stock.

Thus, following the transaction, Distributing will be wholly owned by A, and Controlled will be owned equally by B and C. B and C will cause Controlled to elect to be treated as an S corporation.

The following representations have been made in connection with the proposed transaction:

- (a) The fair market value of the Controlled stock to be received by B and C will be approximately equal to the fair market value of the Distributing stock surrendered by these shareholders in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

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- (c) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operations, and with regard to Distributing, there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) Following the transaction, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of the business conducted by Distributing prior to consummation of the transaction.
- (e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: to resolve shareholder disputes which have negatively affected the operations of Distributing. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (f) Distributing is an S corporation. Controlled will elect to become an S corporation pursuant to § 1362(a) on the first available date after the distribution and there is no plan or intention to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.
- (g) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in Distributing or Controlled after the transaction.
- (h) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction, other than through stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696.
- (i) There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after the transaction, except in the ordinary course of business.
- (j) Controlled is not assuming liabilities or receiving assets subject to liabilities from Distributing.
- (k) Distributing neither accumulated its receivables nor made extraordinary payments of its payables in anticipation of the transaction.

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- (l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.
- (m) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (n) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (o) The distribution is not part of a plan or series of related transactions (within the meaning of § 355(e)) pursuant to which one or more persons will acquire, directly or indirectly, stock possessing 50% or more of the total combined voting power of all classes of stock of Distributing or Controlled, or stock possessing 50% or more of the total value of all classes of stock of Distributing or Controlled.
- (p) No investment credit has been or will be claimed with respect to any property being transferred from Distributing to Controlled.

Based solely on the information submitted and representations made, we hold as follows:

- (1) The transfer by Distributing of certain assets of Business 1 to Controlled solely in exchange for all of the stock of Controlled followed by the distribution of all of the Controlled stock equally to B and C in exchange for all of B's and C's Distributing stock, as described above, will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be "a party to a reorganization" within the meaning of § 368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of the Distributing assets to Controlled in exchange for the Controlled stock (§§ 361(a)).
- (3) Controlled will recognize no gain or loss upon the receipt of the Distributing assets in exchange for the Controlled stock (§ 1032(a)).
- (4) Controlled's basis in each asset to be received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the transaction (§ 362(b)).
- (5) Controlled's holding period for each asset to be received from Distributing will include the period during which Distributing held such asset (§ 1223(2)).

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- (6) Distributing will recognize no gain or loss upon the distribution of the Controlled stock to B and C (§ 361(c)(1)).
- (7) B and C will recognize no gain or loss (and no amount will be included in their income) upon the receipt of Controlled stock in exchange for their Distributing stock (§ 355(a)(1)).
- (8) The basis of the Controlled stock to be received by B and C, respectively, in the transaction will equal their respective bases in the Distributing stock surrendered in exchange therefor (§ 358(a)(1)).
- (9) The holding period of the Controlled stock to be received by B and C in the transaction will include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the date of the distribution (§ 1223(1)).
- (10) Controlled is not ineligible to elect S corporation treatment in its first taxable year because it had an ineligible shareholder for the moment Distributing owned its stock.
- (11) Controlled will be subject to § 1374 with respect to any asset transferred to Controlled from Distributing to the same extent Distributing was subject to § 1374. For purposes of § 1374, Controlled's recognition period will be reduced by the portion of Distributing's recognition period that expired before Distributing's transfer of these assets to Controlled (§ 1374(d)(8)).

We express no opinion about the tax treatment of the proposed transaction under other provisions of the Internal Revenue Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings. We specifically express no opinion as to whether Distributing's S corporation election is valid or whether Controlled's intended S corporation election will otherwise be valid.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel (Corporate)

By *Michael J. Wilder*

Michael J. Wilder  
Assistant to the Chief, Branch 3